

The Heritage Foundation

PRESIDENT'S ADVISORY  
PANEL  
ON FEDERAL TAX REFORM

# Heritage Memorandum

Presented to the President's Advisory Panel on Federal Tax Reform  
May 27, 2005

## **The President's Advisory Panel on Tax Reform Should Recommend the Current System Be Replaced by a Flat Tax**

by DANIEL J. MITCHELL, Ph.D.,  
McKenna Senior Fellow in Political Economy



214 Massachusetts Avenue, NE  
Washington, DC 20002  
(202) 546-4400 • [heritage.org](http://heritage.org)

## **The President's Advisory Panel on Tax Reform Should Recommend a Flat Tax**

*Daniel J. Mitchell*  
*McKenna Senior Fellow in Political Economy*  
*Thomas A Roe Institute for Economic Policy Studies*

Congratulations to the members of this advisory panel for undertaking the task of developing proposals to reform the tax system. As you know, there is a widespread consensus that the current tax system is a complicated failure that hinders the nation's growth while allowing the politically well-connected to manipulate the system to get special breaks not available to average workers and businesses. This is stimulating a great deal of interest in shifting to a simple and fair flat tax.

The United States should move quickly to a flatter, simpler, more pro-growth tax system. In a competitive global economy, jobs and capital flow to jurisdictions with better tax law.

Traditionally, this process of "tax competition" has benefited the United States, but there is growing evidence that America is falling behind. Nations around the world are lowering tax rates and reforming their tax systems. Indeed, nine nations in the former Soviet Bloc have adopted versions of the flat tax.<sup>1</sup> These pro-growth reforms are yielding impressive results and are a roadmap for this panel and U.S. policymakers.

### **What Is a Flat Tax?**

Unlike the current system, the flat tax is simple, fair, and good for growth. Instead of the 893 forms required by the current system,<sup>2</sup> the flat tax is based on two postcard-size forms: one for labor income and

---

<sup>1</sup>For the latest updates on the global shift to flat taxes, see [www.russiaeconomy.org/comments.html](http://www.russiaeconomy.org/comments.html).

<sup>2</sup>Based on an April 19, 2005, Web search at [www.irs.gov/formspubs/index.html](http://www.irs.gov/formspubs/index.html)

The Heritage Foundation

one for business and capital income. Unlike the current system, which discriminates based on the source of income, use of income, and level of income, the flat tax treats all taxpayers equally, thus fulfilling the “Equal Justice Under Law” principle etched above the Supreme Court. And unlike the current system, which punishes people for contributing to the nation’s wealth, the flat tax lowers marginal tax rates and eliminates the tax bias against saving and investment, thus ensuring better economic performance in a competitive global economy.

There have been several flat tax proposals over the years, all of which are based on the path-breaking proposal developed by two Hoover Institution economists.<sup>3</sup> While no two of these plans are identical, they all share common features, and these shared elements fix the major flaws of the current Internal Revenue Code. It also is worth noting that simplicity and fairness are natural consequences of these component features of tax reform. The major features of a flat tax are:

**A single flat rate.** All flat tax proposals have a single rate, usually less than 20 percent. The low flat rate solves the problem of high marginal tax rates by reducing penalties against productive behavior such as work, risk-taking, and entrepreneurship.

**Elimination of special preferences.** Flat tax proposals eliminate provisions of the code that bestow preferential tax treatment on certain behaviors and activities. Getting rid of deductions, credits, exemptions, and other loopholes solves the problem of complexity, allowing taxpayers to file their tax returns on a postcard-size form.

---

<sup>3</sup>Robert Hall and Alvin Rabushka, *The Flat Tax* (Stanford, Cal.: Hoover Institution Press, 1995), at [www-hoover.stanford.edu/publications/books/flattax.html](http://www-hoover.stanford.edu/publications/books/flattax.html).

The Heritage Foundation

**No double taxation of savings and investment.** Flat tax proposals eliminate the tax code's bias against capital formation by ending the double-taxation of income that is saved and invested. This means no death tax, no capital gains tax, no double-taxation of saving, and no double-tax on dividends. By taxing income only one time, a flat tax will be easier to enforce and more conducive to job creation and capital formation.

**Territorial taxation.** Flat tax proposals are based on the common-sense notion of "territorial taxation," meaning that governments should only tax income earned inside national borders. By getting rid of "worldwide taxation," a flat tax enables U.S. taxpayers and companies to compete on a level playing field around the world since many other nations already rely on this principle.

**Family-friendly.** All flat tax proposals have one "loophole." Households receive a generous exemption based on family size. A family of four, for instance, would not begin to pay tax until its annual income reached more than \$30,000.<sup>4</sup>

## **Advantages of a Flat Tax**

There are two principal arguments for a flat tax: growth and simplicity. Many economists are attracted to the idea because the current tax system, with its high rates and discriminatory taxation of savings and investment, reduces growth, destroys jobs, and lowers incomes. A flat tax would not eliminate the damaging impact of taxes altogether; but by dramatically lowering rates and ending the tax code's bias

---

<sup>4</sup>See, for instance, H R 1040, introduced by Congressman Burgess of Texas, at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109\\_cong\\_bills&docid=fh1040ih.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_bills&docid=fh1040ih.txt.pdf).

The Heritage Foundation

against savings and investment, it would boost the economy's performance when compared with the present tax code.

For many Americans, however, the most persuasive feature of a flat tax is its simplicity. The complicated documents and instruction manuals taxpayers struggle to decipher every April would be replaced by a brief set of instructions and the numerous forms by two simple postcards. This radical reform appeals to citizens who not only resent the time and expense consumed by their own tax forms, but also suspect that the existing maze of credits, deductions, and exemptions gives a special advantage to those who wield political power and can afford expert tax advisers.

If enacted, a flat tax would yield major benefits to the nation, including:

**Faster economic growth.** A flat tax would spur increased work, saving, and investment. By increasing incentives to engage in productive economic behavior, it also would boost the economy's long-term growth rate. Even if a flat tax boosted long-term growth by as little as 0.5 percent, the income of the average family of four after 10 years would still be as much as \$5,000 higher than it would be if current tax laws remained in effect.

**Instant wealth creation.** According to Harvard economist Dale Jorgenson, tax reform would boost national wealth by nearly \$5 trillion.<sup>5</sup> The reason: All income-producing assets would rise in value since the flat tax would increase the after-tax stream of income they generate.

---

<sup>5</sup>Dale W. Jorgenson, "Efficient Taxation of Income," *Harvard Magazine*, March/April 2002, at [www.harvard-magazine.com/on-line/030388.html](http://www.harvard-magazine.com/on-line/030388.html).

## **New Analysis Shows Faster Growth with Flat Tax**

*William W. Beach*

*Director, Center for Data Analysis*

Among the many advantages of moving to a flat tax is faster economic growth. Recently completed work by economists in The Heritage Foundation's Center for Data Analysis underscores this benefit.<sup>6</sup>

According to this analysis, adopting a 17 percent flat tax would lead to significant improvements in U.S. economic performance after the first 10 years of its implementation. Specifically, this new tax system would:

- Lead to 3.8 million more jobs by the end of the tenth year;
- Add \$545 billion to gross domestic product in the tenth year alone;
- Increase the level of personal savings by 50 percent;
- Raise non-residential investment by 9 percent; and
- Expand the nation's capital stock from \$17.8 trillion in 2014 to \$19.1 trillion.

---

<sup>6</sup>This analysis is described in an internal memorandum, "Conventional Revenue Estimates for Tax Cut Extensions and the Flat Tax," that is available upon request and will be the subject of a forthcoming CDA *Report* on the economic and fiscal effects of the flat tax.

The Heritage Foundation

**Simplicity.** Complexity is a hidden tax amounting to more than \$100 billion. This is the cost of tax preparation, lawyers, accountants, and other resources to comply with the Internal Revenue Code. The IRS even admits that the current tax code requires taxpayers to devote 6.6 billion hours each year to their tax returns.<sup>7</sup> Yet even this commitment of time is no guarantee of accuracy. The code is so complex that even tax experts and the Internal Revenue Service often make mistakes. All taxpayers, from General Motors to a hamburger-flipping teenager, would be able to fill out their tax return on a postcard-size form, and compliance costs would drop by tens of billions of dollars.<sup>8</sup>

**Fairness.** A flat tax would treat people equally. A very wealthy taxpayer with 1,000 times the taxable income of another taxpayer would pay 1,000 times more in taxes. No longer, however, would the tax code penalize success and discriminate against citizens on the basis of income. Tax burdens no longer would depend on the number of lawyers, lobbyists, and accountants on the payroll.

**An end to micromanaging and political favoritism.** The flat tax gets rid of all deductions, loopholes, credits, and exemptions. Politicians would lose all ability to pick winners and losers, reward friends and punish enemies, and use the tax code to impose their values on the economy. Not only does this end a major source of political corruption, but it also is pro-growth since companies no longer would squander resources in lobbying politicians or making foolish investments just to obtain favorable tax treatment.

**Increased civil liberties.** Under current law, people charged with murder are presumed innocent and thus have more rights than taxpayers dealing with the Internal Revenue Service. A flat tax, by contrast, eliminates almost all sources of conflict between taxpayers and the government. Moreover, infringements

---

<sup>7</sup>Mary Dalrymple, "Americans Spend 6.6 Billion Hours on Taxes," Associated Press, April 15, 2005, at <http://apnews.myway.com/article/20050415/D89FVDJ80.html>

The Heritage Foundation

on freedom and privacy would fall dramatically since the government no longer would need to know intimate details about each taxpayer's financial assets.<sup>9</sup>

**Competitiveness.** In a global economy, it is increasingly easy for jobs and capital to escape high-tax nations and migrate to low-tax nations. This means the reward for good tax policy is greater than it has ever been—but it also means that the penalties for bad policy are greater than they have ever been. This is why so many nations are lowering tax rates and reforming their tax systems.<sup>10</sup> A flat tax will make America a magnet for investment and job creation.

## **Beware the Value-Added Tax**

Although a value-added tax (VAT) it is a relatively non-destructive way to collect revenue in concept, it should be rejected because in practice it almost certainly would be used to finance an expansion in the size and cost of government. The only condition that would make a VAT acceptable is complete repeal of all income taxes—including an amendment to the Constitution to prohibit a future Congress from re-imposing taxes on any type of income.

A VAT is levied on the “value added” to goods and services as they pass through each stage of the production process. The VAT is a “consumption-based” tax system, which is a fancy way of saying that, unlike the existing personal and corporate income tax system, it does not double-tax saving and

---

<sup>8</sup>Arthur Hall, “Compliance Costs of Alternative Tax Systems,” *Special Brief*, The Tax Foundation, Washington, D.C., June 1995.

<sup>9</sup>Daniel Mitchell, “Tax Reform: The Key to Preserving Privacy and Competition in a Global Economy,” *Policy Report* No. 171, Institute for Policy Innovation, Lewisville, Texas, February 27, 2002, at [www.ipi.org/ipi/IPIPublications.nsf/PublicationLookupFullText/C9BD6A1A962A316D06256B590025A9A9](http://www.ipi.org/ipi/IPIPublications.nsf/PublicationLookupFullText/C9BD6A1A962A316D06256B590025A9A9).

<sup>10</sup>For more information on the liberalizing impact of “tax competition,” see Daniel J. Mitchell, “The Economics of Tax Competition: Harmonization vs. Liberalization,” in *2004 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones and Company, Inc., 2004), at [www.heritage.org/research/features/index/ChapterPDFs/chapter2.pdf](http://www.heritage.org/research/features/index/ChapterPDFs/chapter2.pdf).



The Heritage Foundation

investment. In this regard, the VAT has the same “tax base” as the flat tax and national retail sales tax. All of these systems tax labor and capital income, but only one time. The flat tax is levied one time—at one low rate—when income is earned, while the VAT and national retail sales tax are levied one time—at one low rate—when income is spent.

A VAT sounds attractive in theory, but it does not yield positive results. Many countries already impose VATs, and the results of this “real world” experiment have been dismal. Based upon historical evidence and economic research, it is clear that adoption of a VAT will have several adverse consequences.

**Effect #1: A VAT triggers more government spending and higher tax burdens.** International evidence clearly shows that a VAT is very likely to increase the aggregate burden of government. The burden of government in Europe used to be only slightly larger than it was in the United States. Yet since the late 1960s, when various nations began to implement VATs, Europe’s overall tax burden has climbed rapidly. These higher taxes have translated into higher spending. Government spending in European Union nations consumes a much larger share of economic output—in some cases, more than 50 percent of economic output. Even if state and local government spending is included, the burden of government spending in the United States is much lower.

**Effect #2: A VAT slows the economy and destroys jobs.** By taking resources out of the productive sector of the economy and transferring them to the government, a VAT would slow economic growth and undermine job creation. The VAT drives a larger wedge between pre-tax income and post-tax consumption, thereby reducing incentives to engage in productive behavior. The economic damage of a

The Heritage Foundation

VAT might be avoided if the tax replaced other forms of taxation, but the European experience shows that VATs almost always have resulted in a larger aggregate tax burden.

**Effect #3: A VAT means higher income taxes.** In most—if not all—developed nations, there are politicians who are fixated on the distribution of the tax burden. In other words, they want “rich” people to pay a certain percentage of the tax burden. But a VAT is evenly distributed among income classes, meaning that the imposition of such a tax would reduce the relative “progressivity” of the overall tax burden. To obtain political support from the left, politicians who are seeking to impose a VAT or to increase the rate of an existing VAT therefore often simultaneously increase income tax rates to preserve the progressivity of the entire tax code.

**Effect #4: A VAT means heavy administrative costs on business and taxpayers.** A VAT conscripts businesses to serve as tax collectors for the government. This is particularly true if lawmakers impose a credit-invoice VAT, as has been the case in almost every nation that adopts the tax. Under this system, every company and entrepreneur would be forced to keep records on every purchase and submit detailed forms to the IRS. The administrative burden of the VAT would be especially severe if policymakers chose, as most proponents of the new tax advocate, to exempt certain goods and services.

Firms then would have to segregate records according to tax status and submit numerous separate forms to the tax authorities.

Enacting a value-added tax would be a costly mistake for American consumers and workers. Once adopted, the VAT would prove irresistible to politicians anxiously looking for money to pay for new

The Heritage Foundation

programs. The VAT also would undermine entitlement reform since politicians would be able to gradually increase the tax to finance promised benefits.

The tax rate doubtless would climb, financing a surge of new federal spending. The result: a stagnating economy and fewer jobs for American workers. The value-added tax may have some attractive theoretical qualities compared to taxes on income and production, but in the real world, it simply would be another burden on an already overtaxed economy.

## **Conclusion**

The current income tax system punishes the economy, imposes heavy compliance costs on taxpayers, rewards special interests, and makes America less competitive. A flat tax would reduce these ill effects dramatically. Perhaps more important, it would reduce the federal government's power over the lives of taxpayers and get the government out of the business of trying to micromanage the economy.

The VAT, by contrast, is a risky approach. It has attractive theoretical features, but in the absence of Constitutional changes, it almost surely would wind up being an additional source of revenue that is used to expand the burden of government.

While there will never be a tax that is good for the economy, this panel should recommend adopting a flat tax that moves the system much closer to where it should be: raising the revenues government demands in the least destructive and least intrusive way possible.